

Internal Revenue Service

memorandum

CC:INTL-0502-91

Br5:MHogan

date: SEP 3 _ 1991

to:

from:

subject: (INTL-0502-91)

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ISSUES

- (1) whether the renegotiation of CFC debt, under the facts presented below, constitutes a debt for equity swap resulting in a gain or in original issue discount;
- (2) what documents should be requested in order to further develop the debt swap issue on audit;
- (3) whether a loan reduction to a CFC resulted in discharge of indebtedness income;
- (4) whether the CFC classification and 901 conclusions in a withdrawn Technical Advice Memorandum should be followed for the same issues in the current audit cycle.

CONCLUSIONS

- (1) Although the facts indicate that some elements of a debt for equity swap under Rev. Rul. 87-124 are present, without more detailed information about the transaction, we cannot respond to the swap and OID questions presented.
- (2) In order to better substantiate any debt swap issue, documents and correspondence regarding short and long term debt incurred and loan renegotiations should be requested from CFCs, members of the lender bank consortium, and taxpayer's financial advisors through use of IDR and summonses. Suggested requests are provided. We are pursuing the issue of whether a summons may be used to request records from the and . In an effort to obtain further

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information on [REDACTED] debt swaps, we will also attempt to identify other taxpayers/financial institutions with [REDACTED] operations or significant [REDACTED] debt holdings who may have engaged in similar debt renegotiations. [REDACTED] will also be contacted once consortium members are identified.

(3) Further information is required before it can be determined whether a loan reduction resulted in discharge of indebtedness income.

(4) The entity classification and section 901 conclusions provided in the prior TAM should be followed in the current audit cycle.

FACTS

[REDACTED] is the parent company to [REDACTED] (" [REDACTED] "), a domestic holding corporation involved in mining activities throughout the world. [REDACTED]'s international activities are conducted through subsidiaries owned by [REDACTED] (" [REDACTED] "). [REDACTED] is a Delaware Corporation wholly owned by [REDACTED].

[REDACTED] owns [REDACTED] percent of [REDACTED] (" [REDACTED] "), a Delaware corporation. [REDACTED] in turn, owns [REDACTED] percent of [REDACTED] (" [REDACTED] "), a [REDACTED] entity. The remaining [REDACTED] percent of [REDACTED] is owned by [REDACTED] (" [REDACTED] "), a Delaware corporation wholly owned by [REDACTED].

[REDACTED] owns [REDACTED] percent of [REDACTED] (" [REDACTED] "), also a [REDACTED] entity. The remaining [REDACTED] percent of [REDACTED] is held by unrelated [REDACTED] residents.

[REDACTED] and [REDACTED] are controlled foreign corporations within the meaning of sections 957(a) and 951.

[REDACTED]'s [REDACTED] tax years are currently under audit. The taxpayer's tax and foreign financial statements indicated substantial reductions in outstanding long term debt owed to U.S. bank(s). Part of this reduction may be attributable to an advantageous debt transaction involving the renegotiation of \$ [REDACTED] of a dollar denominated loan payable to a consortium of U.S. banks. The loan was apparently made in [REDACTED] and may be held by one of [REDACTED]'s CFCs. The exact amount this outstanding debt is unknown.

It is believed that one of [REDACTED]'s CFCs initially approached the U.S. Bank(s) to renegotiate part of an outstanding loan. However, instead of a straight renegotiation, the parties may have entered into a transaction in which the [REDACTED] government agreed to repay the consortium \$[REDACTED] of its debt to the extent that a similar amount (\$[REDACTED] worth of pesos) was reinvested in [REDACTED] by [REDACTED]'s CFC. The [REDACTED] government might be willing to enter such a transaction under its LDC debt repayment program guaranteeing foreign investment to the extent of U.S. debt repayment.

As part of the transaction, the [REDACTED] central bank may have credited the CFC's account for \$[REDACTED] in pesos. Additionally, the U.S. bank may have renewed the CFC loan at a steep discount. The transaction could be achieved solely by book entries between the three parties. Although stock issuances are not present, the transaction has elements similar to Situations 1 and 2 of Rev. Rul. 87-124, 1987-2 C.B. 205.

Corporate documents reviewed in the course of audit made reference to the renegotiation of a \$[REDACTED] loan made by the [REDACTED] government to [REDACTED] in [REDACTED] to finance export operations. Minutes from a [REDACTED] Board of Directors meeting indicated that the loan was reduced to \$[REDACTED], indicating possible discharge of indebtedness income of \$[REDACTED]. However, the \$[REDACTED] loan amount does not reconcile with export facility and other long term debt listed in the taxpayer's [REDACTED] and [REDACTED] annual reports. Alternatively, the \$[REDACTED] might also have been a line of credit from the [REDACTED], and possibly a component of the \$[REDACTED] debt renegotiation.

In [REDACTED], the National Office prepared a Technical Advice Memorandum addressing, among other things, the entity classification of [REDACTED] and [REDACTED] and the creditability of the [REDACTED] "tertiary" tax under section 901 of the Code. The TAM concluded that [REDACTED] and [REDACTED] were properly classified as corporations under section 7701, notwithstanding that [REDACTED] was considered a partnership under [REDACTED] law. The TAM also concluded that the tertiary tax paid by [REDACTED] and [REDACTED], as partners of [REDACTED], was a creditable tax.

The TAM was withdrawn in [REDACTED] on the basis that the section 901 result would be changed by a regulation amendment, legislation, or a new ruling. The TAM issues were settled in the [REDACTED]'s favor for years [REDACTED]. The same

issues have been raised in the current audit cycle. Information submitted in connection with the TAM indicates that [REDACTED] law changed so that beginning in [REDACTED], the tertiary tax applies only at the time and to the extent of actual distributions. [REDACTED] made dividend distributions of \$ [REDACTED] in [REDACTED] and \$ [REDACTED] in [REDACTED].

DISCUSSION

I. Debt for Equity Swap and OID Issues.

Advice was requested on whether the renegotiation of \$ [REDACTED] of a CFC's loan payable constitutes a debt for equity swap resulting in a gain under Rev. Rul. 87-124, 1987-2 C.B. 205. Advice was also requested on whether an OID issue was raised by this transaction. Although some elements of Rev. Rul. 87-124, Situations 1 and 2, are present here, without more detailed information about the transaction, we cannot respond to the swap and OID questions presented.

II. Document Requests.

In order to obtain documents which might substantiate the debt renegotiation(s) and any swap transaction, we recommend that the following steps be taken:

- (1) Submit an IDR to [REDACTED] requesting the following:
 - (a) all documents and correspondence regarding any long or short term debt, loan, or line of credit incurred by [REDACTED] or [REDACTED] from [REDACTED] through [REDACTED] and which are directly or indirectly reflected on or in Forms 5471 for years ending [REDACTED], annual audit and financial reports for years ending [REDACTED] and [REDACTED], and Board of Director Minutes dated [REDACTED].
 - (b) all documents and correspondence regarding any loan renegotiation involving [REDACTED] and [REDACTED] during the period [REDACTED]-[REDACTED];
 - (c) any documents held or maintained by [REDACTED], [REDACTED], or any U.S. or foreign [REDACTED] affiliate regarding the \$ [REDACTED] loan at issue (i.e. loan agreements, loan guarantee agreements, repayment schedules, renegotiation agreements);
 - (d) copies of [REDACTED] and [REDACTED] general ledger, general journal, and intercompany debt accounts and substantiation (e.g. accounting work papers) thereof;

- (e) Forms 5471 prepared for [REDACTED] and [REDACTED] for the periods ending [REDACTED], including accounting work papers substantiating entries on Schedules C, D, F, M (or any other pertinent schedules);

If necessary, the IDR should be followed up with a summons.

(2) Identify those U.S. banks making the loans at issue, either individually or as loan participants/members of the U.S. bank consortium. After identification, request the following information by use of summonses:

- (a) any pro formas used by the bank(s) in executing debt repayment by LDC countries or their banking institutions under national debt repayment/foreign reinvestment programs;
- (b) any correspondence, documents, or files existing between the lead bank and other consortium participants regarding repayment by [REDACTED] institutions of U.S. debt to the consortium or consortium member during the period [REDACTED]-[REDACTED];
- (c) any correspondence, documents, or files regarding any loan of consortium/member debt to or loan renegotiation of consortium/member debt by the [REDACTED], any [REDACTED] world wide affiliate, [REDACTED], or [REDACTED] during the period [REDACTED]-[REDACTED];
 - (i) any correspondence, documents, or files pertinent to any party who in any way had an economic impact on any such loan or loan renegotiation;

(3) Request the following information from auditors/public accountants who prepared taxpayer's [REDACTED] and [REDACTED] foreign annual and audit reports by use of summonses:

- (a) accounting work papers substantiating current and long term debt and credit agreement amounts listed in the annual reports and annual audit reports, including accompanying footnotes, and Statement of Sources and Applications of Funds/Statement of Cash Flows, prepared for years ending [REDACTED] and [REDACTED].

We are currently investigating whether [REDACTED] and [REDACTED] can be summoned to provide any pertinent Chilean debt reduction information. An answer will be provided as soon as possible.

While you are awaiting answers to the IDR and summonses, we will attempt to identify those companies and financial institutions with substantial [REDACTED] debt. Those corporations and institutions will be requested to provide any information they have regarding [REDACTED] debt swaps. Additionally, if the identity of the bank consortium members involved in the present transaction can be provided to us, [REDACTED] will be contacted to obtain any pertinent records and documents.

Once more information is known about the transaction, we would be pleased to make a determination on any Rev. Rul. 87-124, OID, and income from discharge of indebtedness issues raised by the transaction.

III. The Precedential Value of A Prior TAM Regarding Entity Classification and Application of Treas. Reg. § 1.901-2(b)(2)(ii).

A project to reconsider the classification and 901 conclusions reached in the prior TAM was recently opened by Charles Besecky and Judith Cavell in the Office of Associate Chief Counsel (International), Branch 4. However, no conclusions have yet been reached. Additionally, no changes have been made to Treas. Reg. § 1.901-2(b)(2)(ii) since the 1987 TAM. Thus, for your purposes, the conclusions reached by the prior TAM remain valid.

Although we understand that [REDACTED] law changed after [REDACTED] to require actual distributions before the tertiary tax is imposed, this does not change the creditability of any tertiary taxes paid by [REDACTED] and [REDACTED] in the years under audit. We note that [REDACTED] made actual dividend distributions to [REDACTED] and [REDACTED] in [REDACTED] and [REDACTED]. We understand that under pre-1984 [REDACTED] law, dividend distributions of amounts previously subject to the tertiary tax would not be subject to the [REDACTED] primary tax or a second tertiary tax. Nonetheless, we suggest that you require the taxpayer to fully document that no second taxes were levied by [REDACTED] directly or indirectly, on these actual distributions.

If you have any further questions, please contact Margaret Hogan at FTS 566-6795.

cc: [REDACTED]